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Credit Market Update

by Michael T. Newsome

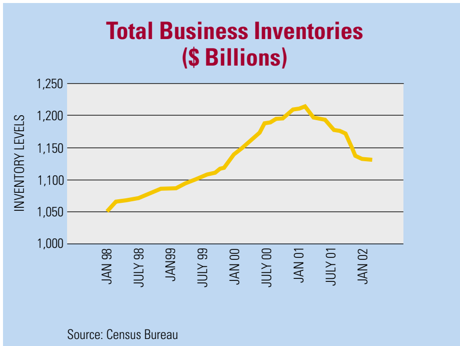
If you can believe the numbers (and we do), the recession of 2001-2002 is drawing to a close. It appears that this economic downturn will be one of the mildest on record. A remarkable testament to the resilience of the U.S. economy, given the severe decline in equity values, the massive retrenchment in technology investment, and the unprecedented tragedy of last September.

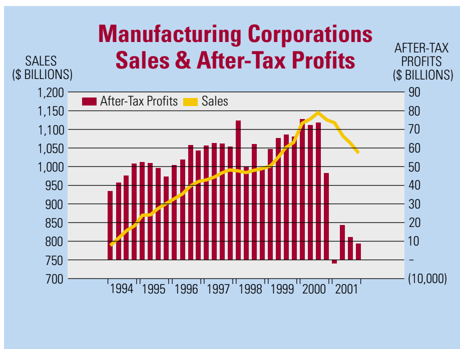
In the past several months, signs have emerged that some of the forces that have been restraining the economy over the past year are starting to diminish and that activity is beginning to firm. Clearly, the benefits of the recovery are not yet being felt in all sectors. Hard hit by the decline in technology and aerospace, the Pacific Northwest continues to lag the national economy. Nationally, however, the speed of the turnaround has been remarkable.

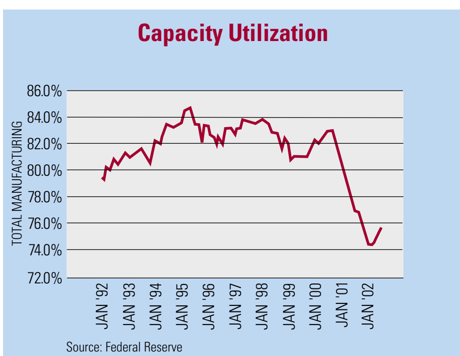
The current downturn—unlike others in the post-war period—was not led by a fall in consumer spending. Rather, it began as a sharp reduction in business investment even as consumer spending remained relatively robust. Consumer spending has continued to hold up, in the face of what would seem to be some pretty dire circumstances. Eleven interest rate cuts by the Fed, in the span of less than a year, have been a positive contributor.

Lower interest rates have strengthened the value of homes. According to the Economist, average U.S. house prices have demonstrated the largest increase ever, rising by 9% in real terms over the past year. And, it is housing where the majority of Middle America's wealth is invested. These higher values, together with the lowest mortgage rates in decades, have encouraged consumers to continue spending (although somewhat at the expense of higher consumer debt). Last year's tax rebate also helped.

While consumers did their best to support the economy, business investment fell off a cliff, precipitating a rapid melt down in corporate earnings. Investment in information and telecommunications technology that was a major driver during the boom has been slashed to the bone in the aftermath. As is







typical in an economic contraction, inventory investment took the first hit. The liquidation of inventories was sizable and swift. Near-term economic uncertainty, coupled with the higher risk premiums demanded by lenders and more expensive equity capital, caused business managers to severely cut back on capital spending.

Although this recession will be remembered as mild in terms of its impact to GNP, records will show that it has been one of the harshest in memory when measured by the changes in corporate profits. After-tax corporate profits declined by nearly 16% last year, one of the worst annual profit declines since World War II. Likewise, capacity utilization recorded the biggest drop in a decade.

The key to the continuing strength of this recovery is what will happen to corporate profits and investment spending. On these points, the jury is still out. Anecdotal evidence from our clients seems to indicate that business conditions are improving, at least on the sales front. However, taking back the price discounts that were given up during the period of slack demand remains problematic.

So while the economic sector in which we eke out our livelihood remains under

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pressure, we are sensing a renewed willingness on the part of our clients to take risks. This restoration of confidence, particularly if it can be married with a relaxation of underwriting standards on debt capital, will meaningfully accelerate the economic recovery.

Past readers of *INSIGHT* will recall that we held a more pessimistic view of the economic situation, anticipating a more protracted period of economic softness. In fact, the economy has proven to be more resilient than we had expected. What did we miss? What has changed to provide such resilience and is it reasonable to expect that those factors will continue?

While we do not pretend to know all of the reasons, there are three phenomena that appear to have softened the downturn and accelerated the rebound, including:

1. The access to real-time information by

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business decision-makers;
2. Increased flexibility in the economy as a result of deregulation; and
3. Innovation in the financial sector.

In today's world, business decision-makers have access to a tremendous amount of real-time information across companies, industries, and countries. Access to identical real-time information allows a more rapid response to changing business conditions. In this manner, imbalances that historically would have taken time to restore can be addressed quickly. Furthermore, information technology has meaningfully contributed to productivity improvements.

In the past decades, many industries have been deregulated, both in the U.S. and internationally. In the United States, air travel, transportation, energy and financial markets are today allowed to respond to market forces. Internationally the list is much longer. Unrestrained, the invisible hand proves to be a powerful motivator.

Deregulation in the financial sector has been especially important in enhancing overall economic resilience. New financial products have enabled risk to be dispersed more effectively to those willing and capable of bearing it. As a consequence, shocks to the system are less likely to cascade through the financial markets causing an unrestrained meltdown.

While each period of expansion and contraction is unique, these changes are, we think, here to stay. Although, unlikely to keep us out of a recession, these forces will continue to provide further resilience to the U.S. economy. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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